Office-Supreme Court, U.S.
FILED
JUL 31 1981
ALEXANDER L. STEVAS,
CLERK

No. 80-2154

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

ZENITH RADIO CORPORATION, et al.,
Petitioners,

v.

ROBERT EDWARD McGRATH,
Respondent.

REPLY BRIEF IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

HENRY L. PITTS
JOSEPH S. WRIGHT, JR.
JAMES GUY McCONNELL
LELAND W. HUTCHINSON, JR.
55 West Monroe Street
Chicago, Illinois 60603
(312) 372-5600
PHILIP J. CURTIS
EDWARD McCAUSLAND
JOHN BORST, JR.
1000 Milwaukee Avenue
Glenview, Illinois 60025
(312) 391-7000
Attorneys for Petitioners

Of Counsel:
ROOKS, PITTS, FULLAGAR AND POUST
July 31, 1981

Pandick Press Midwest, Inc., Chicago • 454-7600

TABLE OF CONTENTS

PAGE

1. Respondent's Admittedly False 10b-5 Allegation Cannot Create Federal Question Jurisdiction 2
2. McGrath's Promised Promotion Could Not Have Been a Factor in His Investment Decision Regarding the Basford Stock 4
3. Petitioners Are Not Precluded From Challenging the Use of an Incorrect Standard of Review 7

Conclusion 9

TABLE OF AUTHORITIES

Cases

PAGE

A. J. White & Co. v. *Securities and Exchange Comm.*, 556 F. 2d 619 (1st Cir.) cert. denied, 434 U. S. 969, 98 S. Ct. 516 (1977) 5

Blue Chip Stamps v. *Manor Drug Stores*, 421 U. S. 723, 95 S. Ct. 1917 (1975) 3, 6

Dixson v. *Newsweek, Inc.*, 562 F. 2d 626 (10th Cir. 1977) 7

Hidell v. *International Diversified Investments*, 520 F. 2d 529 (7th Cir. 1975) 5

Keers and Co. v. *American Steel and Pump Co.*, 234 F. Supp. 201 (S. D. N. Y. 1964) 5

Nelson v. *Serwold*, 576 F. 2d 1332 (9th Cir.), cert. denied, 439 U. S. 970, 99 S. Ct. 964 (1978) 5

Securities and Exchange Comm. v. *R. J. Allen & Assoc. Inc.*, 386 F. Supp. 866 (S. D. Fla. 1974) .. 5

Tully v. *Mott Supermarkets, Inc.*, 540 F. 2d 187 (3rd Cir. 1976) 3

United States v. *Blue Chip Stamp Co.*, 272 F. Supp. 432 (C. D. Cal. 1967), aff'd sub nom., *Thrifty Shoppers Scrip Co.* v. *United States*, 389 U. S. 580, 88 S. Ct. 693 (1968) 6

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

ZENITH RADIO CORPORATION, et al.,
Petitioners,

v.

ROBERT EDWARD McGRATH,
Respondent.

REPLY BRIEF IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

Neither respondent's "additional facts" nor his groundless argument that petitioners have somehow waived their claims of error detract in any way from the importance of this Court's review of the Seventh Circuit's anomalous decision in this case. The court below has extended the scope of Rule 10b-5 into the area of employment, permitting McGrath to perpetrate a fraud on his fellow shareholders and on the Court by deliberately falsifying his Rule 10b-5 allegation in order to counterfeit federal question jurisdiction. For the first time in his brief opposing the certiorari petition ("Br. Opp."), respondent rests his case on the following erroneous assertions, to which petitioners reply:

1. Respondent now contends that the representations made to him about his future promotion prospects were part of the "value of the offer" for his Basford stock and, therefore, affected his investment decision. (Br. Opp. 8-9.)

2. Respondent now claims that petitioners have waived the issue regarding the standard of review on appeal by failing to request special verdicts at trial. (Br. Opp. 14-15.)

Once these two premises are recognized as false, respondent's argument—that the incorrect application of Rule 10b-5 below does not warrant reversal—fails. Moreover, respondent's new definition of the basis for his Rule 10b-5 claim reveals more distinctly than ever the false pretenses under which he asserts the existence of federal jurisdiction. On one hand, McGrath argues that determination of the securities law issues is unnecessary, while on the other hand he argues these same "unnecessary" issues are sufficient to support federal question jurisdiction. The contrived nature of these claims and the concomitant misuse of federal jurisdiction require review of the decision below to protect the integrity of the federal courts and Rule 10b-5.

1. RESPONDENT'S ADMITTEDLY FALSE 10b-5 ALLEGATION CANNOT CREATE FEDERAL QUESTION JURISDICTION.

Respondent describes this controversy as one involving a routine exercise of pendent jurisdiction in conjunction with his prosecution of a colorable federal securities law claim. The controversy actually involves a plaintiff who has deliberately falsified a Rule 10b-5 allegation in order to create the appearance of federal question jurisdiction. The decision below teaches that any plaintiff may profitably engage in such sham pleading, thereby avoiding summary judgment, then admit the allegation to be false at trial, and yet obtain a favorable judgment on an alternative state law count not within the jurisdiction of the federal court.

McGrath offers no defense for his deceptive allegation that he received "inadequate consideration" for his Basford shares, which he used as a pretense for claiming federal question

jurisdiction until after he rested his case at trial, when he finally stipulated that he had been paid a fair price, determined in an arm's length transaction. (R. 1062.) His only justification offered for these acts is their success in the courts below. (Br. Opp. 13.) The fact that there were incorrect jurisdictional rulings below, however, cannot be the basis for justifying a knowingly false pleading. *Tully* v. *Mott Supermarkets, Inc.*, 540 F. 2d 187, 195-96 (3rd Cir. 1976).

McGrath knew when he made the claim of inadequate consideration for the stock he sold that the allegation was false. Moreover, *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 95 S. Ct. 1917 (1975) conclusively eliminated any basis for McGrath's alternative Rule 10b-5 claim, regarding his waiver of his contingent right to purchase Basford stock, eight months before he first asserted the claim. The plain fact that the Rule 10b-5 count was added for the sole purpose of abusing federal jurisdiction was exposed by McGrath's free abandonment at trial of the only allegation which might have supported federal question jurisdiction.[1]

No substantial federal securities claim ever existed in this case. Federal courts are already overburdened with a heavy load of diversity cases which properly belong in state courts. Respondent only alleged federal question jurisdiction as an afterthought, when his diversity allegation was shown to be insufficient. He may not now excuse his deceptive conduct on the basis that his tactics were not conclusively exposed at an earlier stage. The lack of federal jurisdiction throughout this case should now be recognized.

---

[1] The majority below stated that McGrath's Rule 10b-5 claim was not shown to be "obviously frivolous" in upholding jurisdiction. In doing so, the majority relied on precedents in which new but tenuous legal theories allegedly supporting federal jurisdiction were deemed sufficiently "colorable" to support pendent jurisdiction over companion state law claims. We submit that such authorities have never been used to excuse and do not support the practice of falsely pleading *facts* necessary to give "color" to the non-existent federal claim.

2. McGRATH'S PROMISED PROMOTION COULD NOT HAVE BEEN A FACTOR IN HIS INVESTMENT DECISION REGARDING THE BASFORD STOCK.

Respondent contends, without citation of legal authority or logical reason, that the intentions of the purchaser of employee-owned stock regarding continued employment or promotion of the employee are a factor in the employee's investment decision to sell the stock. (Br. Opp. 9.) Petitioners reject this suggestion, which is the only claimed basis for the application of section 10(b) and Rule 10b-5 to this case, because no basis exists in either the legislative history or this Court's interpretations of that statute to extend the federal securities laws to an employment dispute.

Respondent now claims that the value of Zenith's offer for the Basford shares "can depend on many factors in addition to price," admitting that his Rule 10b-5 claim depends on his prospective promotion being included in the consideration paid to him for his stock. (Br. Opp. 8.) No evidence exists supporting such a contention. The record does not reflect any promise or representation to Basford employee-shareholders that they would be retained or promoted in return for the sale of their stock.[2]

If what respondent suggests is true, he defrauded his fellow shareholders, and so far has secured the assistance of the federal courts in collecting his ill-gotten gains. (Pet. at 15 n. 4.) If this result were to stand, the determination of materiality for purposes of Rule 10b-5 would shift from the objective inquiry of what information would affect a *reasonable* shareholder's

---

[2] Contrary to respondent's assertion, petitioners do not claim that "misrepresentations were made 'to a group of selling shareholders'." (Br. Opp. 7.) Petitioners' point is that fraud allegedly suffered by only one of the group of selling shareholders could not have resulted from any deception occurring in connection with the stock transaction. The fact that the shareholders all received admittedly fair value for their shares establishes that McGrath's fraud claims are entirely common law and not federal securities fraud claims.

valuation of the securities to a subjective inquiry of what information, whether or not value related, would affect a *particular* shareholder's decision to sell.

None of respondent's authorities either justifies an interpretation of Section 10(b) and Rule 10b-5 broader than petitioners' or supports the application of those provisions to this case. In fact, in each of the cases cited by respondent where the courts applied Rule 10b-5, it was applied because the misrepresentations directly related to the value of the securities in question.[3]

The court in *A.J. White & Co.* v. *Securities and Exchange Comm.*, 556 F. 2d 619, 623 (1st Cir.), cert. denied, 434 U. S. 969, 98 S. Ct. 516 (1977) upheld Rule 10b-5 liability specifically noting that the nondisclosures directly related to the market acceptance of an initial public offering and, therefore, to the investors' ability to judge whether they were paying fair market price for the stock. The Court in *Hidell* v. *International Diversified Investments,* 520 F. 2d 529, 536 (7th Cir. 1975), applied the same reasoning. In *Nelson* v. *Serwold,* 576 F. 2d 1332, 1336 (9th Cir.), cert. denied, 439 U. S. 970, 99 S. Ct. 964 (1978) the Court also found that the claimed deception pertained to the value of securities purchased or sold, specifically holding that the defendants, officers in control of the corporation, knew that plaintiff had relied on their $5 per share offer as a representation of the stock's fair market value, a representation which defendants knew to be false. Moreover, in *Securities and Exchange Comm.* v. *R.J. Allen & Assoc., Inc.*, 386 F. Supp. 866 (S. D. Fla. 1974) the court, rather than finding simple non-value deception, found that the defendants "engaged in certain practices which so pervaded their business

[3] The court in *Keers and Co.* v. *American Steel and Pump Co.*, 234 F. Supp. 201 (S. D. N. Y. 1964) dismissed the securities claims under Rule 12(b)(6), Fed. R. Civ. P., because no fraud was adequately alleged, only breach of contract claims. *Id.* at 203-04.

that they rendered the entire operation a fraudulent and deceptive scheme and course of conduct designed to defraud investors." 386 F. Supp. at 873.

Respondent's contention that petitioners failed to argue below that Rule 10b-5 prohibits only value related deception displays a fundamental misunderstanding of the law in this area. (Br. Opp. 8.) McGrath readily admits that the "in connection with" and materiality requirements of Rule 10b-5 were raised by petitioners and ruled on by the Seventh Circuit. (*Ibid.*) Petitioners' arguments in section 1A of the petition all focus on the lack of the requisite nexus between the alleged omissions and the securities transaction, and the resulting absence of either connection with the sale of the stock or of materiality to McGrath's investment decision. (Pet. at 10-19.)

Moreover, respondent may not salvage his otherwise groundless Rule 10b-5 claim by relying on the waiver of his conditional right to purchase Basford stock for the reasons noted in section 1B of the petition. Contrary to McGrath's contention, his conditional right was not different from the contractual rights in *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U. S. 723, 95 S. Ct. 1917 (1975). The *Blue Chip* plaintiffs were beneficiaries of the consent decree entered in *United States* v. *Blue Chip Stamp Co.*, 272 F. Supp. 432 (C. D. Cal.), aff'd sub. nom., *Thrifty Shoppers Scrip Co.* v. *United States*, 389 U. S. 580, 88 S. Ct. 693 (1968). The consent decree required the offer of a specified number of shares of stock to the class including the *Blue Chip* plaintiffs at a specified "bargain" price. 421 U. S. at 726-27, 95 S. Ct. at 1920-21. McGrath's conditional opportunity gave him no greater rights.

McGrath is simply incorrect in his unsupported assertion that he sold his contract right to Zenith for value. (Br. Opp. 10.) The record reflects that he attempted to do so, but his request for an employment contract was clearly denied, and McGrath agreed to waive his contingent right anyway. (R.

178.) As Judge Swygert correctly noted below, "*A fortiori* this case has less connection with the purchase of a security than *Manor Drugs.*" (Pet. 27a.)

3. PETITIONERS ARE NOT PRECLUDED FROM CHALLENGING THE USE OF AN INCORRECT STANDARD OF REVIEW.

Significantly, McGrath avoids any attempt to refute petitioners' contention that the majority below applied an incorrect standard of review. The correct standard of review as defined by this Court requires a new trial if any one of respondent's three theories was improperly submitted to the jury. (Pet. at 27.) In this instance, McGrath's Rule 10b-5 claim was improperly submitted to the jury because the record reflects no evidence of fraud occurring "in connection with" any purchase or sale of securities.

Respondent's sole contention in this regard is that petitioners supposedly waived any challenge to the standard of review to be applied to the jury's general verdict by their failure to request special verdicts at trial. Not one of this Court's decisions on that issue even remotely suggests that the applicability of the proper standard of review depends upon petitioners' request for special verdicts at trial. Moreover, respondent cites no authority contradicting the rule of these decisions.

Dixson v. *Newsweek, Inc.*, 562 F. 2d 626 (10th Cir. 1977) does not support McGrath's argument. That decision involved only one theory of liability—libel—although several different defamatory statements were claimed. Newsweek's contention on appeal was that separate questions regarding each allegedly defamatory statement should have been submitted to the jury, but Newsweek made no such request at trial.

McGrath's case, however, was sent to the jury on three distinct legal theories: common law fraud, breach of contract and Rule 10b-5. This Court's standard of review requires

reversal and a new trial on all issues if any one theory of liability was improperly submitted to the jury. The assessment of separate punitive damage awards against the various defendants does not change the applicable standard of review as respondent suggests.

Thus, respondent is incorrect in concluding that petitioners have asked this Court for an "advisory" opinion on the securities questions presented. (Br. Opp. 1.) Determination of the question whether the 10b-5 count was properly sent to the jury is absolutely necessary to the correct resolution of this case.

CONCLUSION

The federal securities laws are meant to insure disclosure of information necessary to investment decisions, not to substitute federal law for state law in questions of hiring and firing employees. The opinion below improperly extending the reach of Section 10(b) and Rule 10b-5 into the arena of employment should not go unreviewed by this Court. Petitioners respectfully submit that a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Seventh Circuit.

Respectfully submitted,

HENRY L. PITTS
JOSEPH S. WRIGHT, JR.
JAMES GUY MCCONNELL
LELAND W. HUTCHINSON, JR.
55 West Monroe Street
Chicago, Illinois 60603
(312) 372-5600
PHILIP J. CURTIS
EDWARD MCCAUSLAND
JOHN BORST, JR.
1000 Milwaukee Avenue
Glenview, Illinois 60025
(312) 391-7000
Attorneys for Petitioners

Of Counsel:
ROOKS, PITTS, FULLAGAR AND POUST
July 31, 1981